1969 #3

THE STRUCTURE OF OUR TAX SYSTEM

Its effect on economic growth and on employment opportunities in Canada

a report published by

THE ONTARIO ECONOMIC COUNCIL

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950 Yonge Street, Toronto, Ontario

November, 1969 1M

Preface

The Ontario Economic Council claims no special expertise on taxation matters. But, as concerned citizens, its members recognize that all of us have a responsibility to participate in any debate on major revisions in tax policies, federal or provincial.

In the light of the recommendations of the Royal Commission on Taxation, and of the decision of the federal taxing authorities to issue a White Paper based, at least in part, on the objectives of that Commission, the Council in July, 1969, asked Kerr Gibson, F.C.A., one of Canada's better known tax analysts, a partner of Clarkson, Gordon and Co., and also a member of the Executive Committee of the Board of Governors of the Canadian Tax Foundation, to set out in a short but comprehensive statement his views on the structure of our tax system with particular emphasis on economic growth and employment opportunities.

Mr. Gibson's report was completed prior to the distribution of the White Paper by the federal Minister of Finance. It does not, as a result, attempt to comment on the proposals detailed therein nor on the equity issues raised earlier by the commission headed by the late Kenneth Carter. These have already been the subject of substantial public discussion.

The Council appreciates the importance of the essential need for equity. Its members also believe, however, that the relationship between taxation and economic growth has not so far been given adequate public attention.

In this area of government the politician plays a key role.

His is the task of balancing demands for service against available financial resources. He tries to find acceptable compromise positions that the majority will support. One of the key political equations consists of reconciling expenditures and taxation.

Side effects complicate his efforts. Because his decisions influence both the economy and his political support, he must take into account a wide range of factors. This is particularly true when a government proposes fundamental changes in the rules of the game as in the case of a reform of the tax structure.

This report is specifically directed toward those who make the ultimate decisions in our political process. It is hoped that it will provide them with a sort of check list against which may be rated the recommendations of the Carter Report and the Benson White Paper.

It should be noted that the president of the Ontario Federation of Labour, while concurring in the publication of the report as a member of the Ontario Economic Council, states that such concurrence should not be interpreted to imply endorsation of the views expressed by the author.

William H. Cranston
Chairman.

November, 1969.

SUMMARY

Changes in the structure of our tax system can materially affect our prospects for economic growth and our ability to develop improved employment opportunities for Canadians.

Criticism of the existing tax system has been concentrated mainly on questions of equity, and it is this that has provided the main impetus for tax reform at both the federal and provincial levels. As a result, the elimination of major inequities in the tax system has come to be accepted as the principal objective of tax reform, and proposed changes are likely to be judged mainly on this basis. However, in view of the crucial importance of economic growth to the achievement of Canada's social and economic goals, at least equal attention should be given to the effect of changes in tax policy on the factors that contribute to economic growth.

Unfortunately, there is a real danger that insufficient attention will be given to this aspect of current proposals for tax reform in Canada. The effect of changes in the structure of our tax system on factors contributing to economic growth are seldom obvious or easily understood, and are, for this reason, liable to be overlooked in an assessment of proposals designed primarily with a view to achieving a more equitable distribution of the tax burden.

Economic growth is not, of course, an end in itself. It is, however, vital to the achievement of most of the real goals of our society. The maintenance of our political independence, the preservation of national unity, and the economic welfare of our

citizens all depend, to a considerable extent, on the health of the economy. Other social objectives, such as the elimination of poverty, the reduction of regional disparities in wealth and opportunity, provision of adequate housing, medical care and old age security, can be attained, without suffocating the economy, only from the fruits of an expanding economy.

Attempts to solve these problems primarily through redistribution of income and wealth in an economy growing only slowly are likely to prove frustrating here as they have in Great Britain.

The tax structure can affect Canada's ability to attract new industries, particularly in the highly competitive fields in which improvements in productivity are most likely to occur. It can also affect our ability to attract and retain individuals with initiative and enterprise who are motivated by the prospect of creating personal wealth.

It would be highly dangerous to ignore the importance of maintaining a satisfactory relationship between our tax system and that of the United States and other countries with which we have close economic relations. International trade and movements of capital and skilled labour are of far greater importance to Canada than they are to most of the countries with which we trade. Failure to respond to significant changes in the U.S. tax system could well cause serious damage to our economy. Major changes in our tax structure in the absence of comparable changes elsewhere involve similar risks.

The relationship between Canadian and U.S. corporation tax rates is, of course, particularly important. In the last ten years

Canadian rates have increased while U.S. rates have gone down, resulting in an adverse change in the relative rates of about seven percentage points, and leaving Canadian rates higher than U.S. rates by between 2 to 5 points. Current proposals to reduce the U.S. rate by 2 percentage points in 1972 would increase this adverse margin unless Canadian rates are also reduced. While we would probably not gain any material net advantages by reducing our corporate rate substantially below the U.S. rate, considerable harm could be done to the Canadian economy by allowing the present adverse relationship to continue indefinitely.

If revenue requirements make it impossible to restore a satisfactory relationship between Canadian and U.S. corporation tax rates without increasing some other form of taxation, greater reliance should be placed on commodity taxes. With suitable exemptions or credits against personal income taxes, sales and excise taxes may be substantially less regressive in effect, and are clearly less damaging to the competitive position of our industry, than excessive corporation taxes.

We must also be careful not to discourage individuals with valuable technical or managerial ability from coming to Canada or remaining here. Such individuals find little difficulty in obtaining rewarding employment opportunities south of the border. If we fail to maintain a reasonable relationship between our personal income tax structure and that of the United States, it will become increasingly costly to attract and retain people with the skills we need to develop our full potential.

Estate and inheritance taxes, while serving a social objective, produce relatively little tax revenue. On the other hand, they tend

to inhibit initiative and enterprise that is important to economic growth, and promote conservative investment practice on the part of those who could finance new ventures. The introduction of a capital gains tax, designed to serve the same social objectives, would further weaken the economic motivation on which the growth process relies to an important extent, unless accompanied by a major withdrawal from the estate tax and succession duty fields.

The tax treatment of income derived from foreign operations of Canadian companies has important long term consequences for the development of Canadian industry. If our tax system is designed to discriminate in favour of domestic investment and against foreign investment in order to induce Canadian companies to employ their resources at home, Canadian-controlled industry will be discouraged from expanding abroad to develop operations on the scale required to meet international competition.

Incentives made available through the tax system can be highly effective in promoting the development of economically desirable new business ventures. Subsidies and grants tend to be less successful. Incentives made available to particular industries, such as those presently provided for the mining and petroleum industries, represent a deliberate departure from neutrality in taxation, but are not inequitable in effect. Their main result is to promote greater investment in these industries than would otherwise occur.

Finally, complexity in the tax law involves a drain on valuable skills. Fundamental changes in the tax system would be likely to be particularly disruptive unless handled with considerable care. Major departures from the tax systems employed in other

countries also involve some penalty in terms of our attraction to foreign capital and skilled people.

TAXATION AND ECONOMIC GROWTH

Factors contributing to economic growth

The principal factors contributing to economic growth fall into three broad categories: increase in capital investment, increase in the labour force, and a number of residual factors loosely lumped together and described as "technical change".

A study of the relative importance of these elements of economic growth prepared for the Royal Commission on Taxation* indicates that, of the increase that occurred in the potential Canadian private non-farm output during the period 1926 to 1963, 31% was attributable to increase in labour force, 23% to capital input, and 46% to the residual "technical change" factors. Since we are primarily concerned with economic growth in per capita terms, the increase in output attributable to growth in the size of the labour force is of relatively little significance. The principal contributions to per capita economic growth have come from new capital investment and from the "technical change" category. It is the effect of tax policy on these factors to which we wish to direct attention.

The residual category described as "technical change" is clearly of such importance as to deserve particular attention. This includes such factors as -

- improvement in the quality of the labour force through education and training

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* T.A. Wilson and N.H. Lithwick: Sources of Economic Growth.

- improvement in management skills
- technological developments relating to products and to production and distribution equipment and methods
- innovation in applying new methods and exploiting new opportunities
- better utilization of labour and material resources through increased mobility in the labour force, discovery and exploitation of natural resources and improved effectiveness of capital markets.

In many of these areas, governments contribute directly through public expenditures on education and training, health and social services, transportation and communication facilities, scientific research, surveys of natural resources and so on. Other government activities affecting such matters as monetary policy, supervision of financial markets and institutions and trade relations with other countries also play an important role in maintaining an environment in which economic growth can be achieved.

Apart from this, the elements of "technical change" and the incentives to saving for new capital investment depend largely on private initiative. While economic motivation is by no means the only stimulus to private initiative, one of the most important achievements of the enterprise economy has been its ability to harness the powerful human instinct of acquisitiveness, and make it work for the benefit of the whole society. The prospect of economic reward provides a major motivation for savings in the private sector and is the principle stimulus to initiative in respect of the various elements of technical change, both of which are vital to economic growth.

It is in this context that we wish to consider the influence of taxation on economic growth. We are here primarily concerned with the effect of changes proposed in the structure of our tax system, rather than with the nature and level of public expenditures financed by tax revenues. It is the structure of the tax system that is currently under review, and our concern is with the way in which changes in the structure may affect essential factors contributing to economic growth.

There are two main areas in which the structure of Canada's tax system can have a most important effect on our economic growth performance. The first of these relates to taxation considerations that affect Canada's ability to attract new investment, particularly in industries that will contribute to improved productivity for our labour force and that have favourable prospects for future development. The aspects of our tax structure that are of particular importance in this connection include the relationship between Canadian and foreign corporation and personal income tax rates, the Canadian tax treatment of income from foreign operations of Canadian companies, and the use of tax incentives, particularly those relating to the extractive industries.

The second area of concern relates to those aspects of the tax structure that affect incentives to initiative and enterprise and the attractiveness of Canada to individuals having these attributes. Of particular importance in this connection is the present system of transfer taxes on wealth, and the relationship of such taxes to the treatment of capital gains.

The tax structure

In meeting its primary objective of raising the revenue required to finance public expenditures, our tax system has also to meet many other objectives, some of which are not easily reconciled. It must ensure reasonable economy of administration, effective enforcement, and a reasonable degree of certainty and simplicity in the law. It is also expected to be capable of influencing economic activity aimed at stability and full employment and to meet other more selective objectives such as improvement in the regional balance of the economy.

No one would seriously contend that our present tax system is the best that could be devised to meet these diverse objectives. Nevertheless, it is well to recognize that it has grown and developed over many years in response to a wide variety of social, economic and political considerations that are difficult to reconcile satisfactorily, and are subject to continual change. It would be foolish to assume that faults identified in the tax structure that have emerged from this process of accommodation and adaptation can be easily overcome through the application of a simple set of principles on which an ideal tax system could be based. Tempting as it may be to pursue theoretically perfect solutions, the practical problems of dealing with conflicting objectives and constantly changing circumstances make it necessary to proceed cautiously and with constant attention to side effects of proposed changes.

One of the most important limiting factors in any consideration of tax reform in Canada is the necessity to ensure that our tax system is satisfactorily accommodated to that of the United States

and other countries with which we have close economic relations. This does not mean that we must copy the tax system of any other country, or follow every change made elsewhere. It does mean, however, that we must constantly bear in mind the relationship of our tax system to that of other countries, and the manner in which this may affect our economy. Differences between our tax system and that of the United States in particular can have considerable effect, either favourable or unfavourable, on the supply of capital and highly skilled personnel in Canada, as well as on our balance of trade. A change in tax structure that might be contemplated with equanimity in the United States might well be impractical for Canada unless a similar change were to be made in the U.S. tax system. Failure to respond in Canada to significant changes in the U.S. tax structure could be equally damaging.

The importance of maintaining a satisfactory relationship between our tax system and that of other countries is frequently overlooked in Canadian studies of the economic implications of tax policy. This is probably due to a tendency to accept as applicable to Canada conclusions reached in similar studies undertaken by economists in the United States, where the internal domestic effects of tax policy are the overriding consideration, and where international tax differentials would have much less relative importance.

The relative importance of international trade and international movements of capital and skilled labour is, of course, vastly greater in the Canadian economy than in that of the United States. In 1968, for example, imports represented over 23% of Canada's gross national product, compared to 5.6% for the United States. Even in the context of a largely self-sufficient economy such as the United States, international tax differentials have recently become a

source of some concern. In Canada's case, with an economy so dependent on foreign trade and capital flows, such differentials assume critical importance.

Corporation income tax rates

One of the principal areas in which the relationship between our tax system and that of other countries can have considerable influence on the Canadian economy is that of corporation income tax. If the Canadian corporate tax rate is significantly higher than that of other countries in which a new enterprise could be located, this will discourage new investment in Canada.

The effect of higher Canadian corporation tax rates may be reduced in some instances where part or all of the higher tax burden can be shifted to consumers, as in the case of industries producing for the Canadian market and protected from foreign competition by tariff barriers, transportation costs or other factors. It may also be offset to some degree by shifting of the higher tax burden to labour, through reduced wage rates relative to countries with lower corporation tax rates. However, the effect of higher rates in Canada can be expected to be most severe in the case of industries that must face competition in the domestic or foreign markets from businesses established in countries with lower corporate tax rates.

The relationship of the Canadian corporation rate to those of other countries is of particular significance to foreign controlled firms considering alternatives for the location of new plants or expanded production facilities. In the case of Canadian-owned companies, the attraction of lower foreign corporation tax rates

may be partially or completely offset by additional foreign taxes imposed on profits withdrawn by dividends, so that the full benefit of the lower foreign corporate rate would apply only to profits retained and reinvested abroad. However, as noted below, higher Canadian corporation taxes will discourage the location in Canada of new production facilities, whether Canadian or foreign owned, in industries faced with effective competition from countries in which tax rates are lower.

The relationship between Canadian and U.S. corporation tax rates is of particular significance in view of the extent of U.S. involvement in many important Canadian industries, and also because the choice of location is less likely to be governed by major differences in important cost factors such as labour rates and transportation costs when the choice is between Canada and the United States than it is when the choice is between Canada and any other country. It is thus important to bear in mind the changes that have already occurred in the relationship between the Canadian and U.S. corporate tax rates in recent years.

Prior to 1959 the Canadian corporation tax rates were considerably lower than the U.S. rates. At that time, the combined Canadian federal and provincial tax rates on corporate profits were between 47% and 49%, compared to the U.S. federal rate of 52%.* This relationship has since been reversed, Canadian rates increasing to between 50% and 53% while U.S. rates were reduced to 48%.**

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* The rates quoted relate to profits in excess of minimum levels to which lower rates apply in both countries.

** Income taxes imposed by a number of U.S. states have increased to some extent in this period. The effect of this is modified by the deductibility of such taxes from the base on which U.S. federal taxes are imposed.

The introduction of temporary surtaxes in both countries (3% in Canada and 10% in the U.S.) has narrowed the gap for the time being, but recent proposals for substantial reductions in U.S. corporation rates (to 46% by 1972) would greatly increase the margin unless Canadian rates are similarly reduced.

This change, from between 3 to 5 percentage points in Canada's favour to an adverse differential of between 2 and 5 points (and possibly increasing by a further 2 points by 1972) has come on top of an increase (from 5% to 15%) in the rate of Canadian withholding tax on dividends paid by a Canadian subsidiary to a U.S. parent company. While U.S. companies were previously subject to lower rates of tax on profits earned in Canada and repatriated by way of dividends than they incurred on profits earned in the United States, they now must face the prospect of a tax burden of close to 60% on repatriated profits earned in Canada compared to the prospect of a 46% U.S. rate of tax on profits earned in the U.S.

This major change in the relationship of Canadian and U.S. corporation tax rates has been accompanied by other changes affecting the relative burden of corporation taxes in the two countries. During this period, depreciation allowances granted to U.S. companies were made substantially more generous, greatly reducing the advantage formerly enjoyed by Canadian companies in this respect. The U.S. investment credit also provided significant relief from U.S. corporation tax on a much more widespread basis than the incentives made available in Canada.

It is, of course, impossible to determine the actual effect such differentials have had on investment decisions in the past,

or to predict the extent of the future response to a change in relative tax rates. Many other factors are at work, and the reaction to changes may be slow to develop. Nevertheless, it seems safe to assume that a significant adverse change in the relationship between the Canadian and U.S. corporation tax rates would have considerable influence on Canada's ability to attract foreign investment, not only from the United States, but also from other countries wishing to establish new production facilities to serve the North American market.

While an unfavourable relationship between Canadian and U.S. corporation taxes can be expected to discourage new investment in Canadian industry, we could not expect a comparable advantage by adopting substantially lower rates that those imposed in the United States. Under the present U.S. tax system, U.S. companies investing in Canada must expect to pay tax at the higher of U.S. or Canadian rates on repatriated profits. Thus the benefit of relatively low Canadian rates would largely accrue to the U.S. Treasury rather than to the U.S. investor.

Corporation taxes vs sales and excise taxes

In the absence of any major reduction in the overall level of government expenditures, any significant reduction in corporation tax rates could be achieved only at the expense of an increase in other forms of taxation or an increase in the national debt. The most satisfactory alternative from the point of view of the effect on economic growth would appear to be increased reliance on consumption taxes, such as sales and excise taxes, imposed on goods and services sold in the domestic market.

There is a tendency to regard consumption taxes as objectionable on the grounds that they are regressive in effect: that is, that they represent a relatively greater burden for those with low incomes than for the well-to-do. However, sales and excise taxes may well be less regressive in effect than corporation taxes if suitable tax exemptions are provided for necessities such as food, housing, children's clothing, etc. Such items represent a relatively high proportion of expenditures at the low end of the income scale. Alternatively, varying rates of tax may be applied on various commodities and services, depending on their degree of importance in family budgeting.

The burden of corporation taxes, and the extent to which they may be regressive in effect, is much more difficult to assess.* To the extent that corporation taxes are not reflected in higher prices to customers, they must be reflected in lower prices paid to suppliers, lower wages to employees, or in lower returns to investors. It is wishful thinking to believe that corporation tax is borne by corporations themselves. Its cost must fall in one way or another on people, and its incidence depends largely on the nature and extent of competition faced by companies in each industry. In cases where higher corporation taxes are passed on to customers by way of increased prices the resulting burden is likely to be more regressive than a properly constructed commodity tax. Even where the corporation tax cannot be shifted, and results in lower

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* See, for example, the discussion of this subject in Appendix to Chapter 3 of the Income Tax Burden on Canadian Shareholders, a study prepared by John R. Allen, published by the Canadian Tax Foundation.

returns to investors, the long term result may be equally regressive in effect. Reduced return on investment can be expected to result in a reduced rate of capital formation with adverse effects on wage rates and the quantity and quality of employment opportunities. While it may be possible to minimize these effects through various monetary, tariff and other fiscal policies, such remedies would, in themselves, almost certainly have regressive effects.

In Canada, industries that are subject to effective competition in both domestic and foreign markets form an important part of the private industrial economy. Companies in these industries cannot generally pass on the burden of higher corporation taxes to their customers and, when they can, this tends to increase the profitability of their competitors in other countries. In the long run, it seems clear that Canadian wage rates and employment opportunities would be adversely affected by Canadian corporation rates materially higher than those prevailing in the United States and other countries with which our industries compete.

Similar considerations do not apply with anything like the same force to consumption taxes such as sales and excise taxes. Such taxes are generally imposed only on purchases for domestic consumption, and apply with approximately equal weight to imported and domestically produced goods. While any increase in domestic taxation tends to exert some upward pressure on domestic labour costs, and thus ultimately on prices, consumption taxes, like personal income taxes, have little direct impact on the relative competitive position or profitability of domestic and foreign producers provided that such taxes are not imposed on equipment and materials entering into the cost of production.

Satisfactory economic growth in Canada will depend on our ability to attract investment to industries that can meet international competition in domestic and foreign markets. It is to these industries that we must look for improved employment opportunities in the future. Since a favourable relationship between Canadian and foreign corporation tax rates is important to the Canadian growth performance, it would seem preferable to rely more heavily on consumption taxes than we have in recent years to meet our increasing revenue requirements.

Personal rates of income tax

Another area in which international tax comparisons are important to Canada's prospects for economic growth is in the rates of personal income tax, particularly those which apply at medium and high income levels. Individuals able to command relatively high incomes by reason of management or technical skills play an essential role in the growth process. They are also highly mobile, and can generally find suitable employment opportunities either in Canada or elsewhere. Significant differences in the marginal rates of tax imposed by Canada and other countries have an important bearing on our ability to attract and retain such individuals.

It is generally accepted that the use of a progressive rate structure for personal income taxation contributes to the overall equity of the tax system. Concepts of equity are not, however, sufficiently precise as to tell us the precise point at which incomes should become subject to tax, the most appropriate degree of progression in rates, and the fair upper limit on high incomes. The matter of primary importance from the point of view of economic

growth would appear to be the relationship of our personal income tax structure to that of other countries that provide equal or better opportunities for highly skilled and enterprising individuals.

It is important to recognize that it is not simply a question of comparing the normal graduated rates of tax applicable to regular remuneration. The existence of provisions offering special tax relief in respect of various forms of incentive compensation can have just as much, if not more, effect on an individual's choice between employment opportunities. The unnecessarily harsh treatment of stock option benefits in Canada compared to the relatively favourable treatment provided in the United States has, for example, greatly reduced the attractiveness of such plans in Canada. On the other hand, the absence of a capital gains tax in Canada has clearly provided an important attraction for individuals with initiative and ability from other countries where capital gains are heavily taxed.

Transfer taxes

Transfer taxes in respect of gifts and inheritances represent a relatively minor source of federal and provincial revenue. In the 1966-67 fiscal year, for example, estate and gift taxes accounted for slightly more than 1% of federal revenue. Succession duties represented less than 3% of total revenue for Ontario in 1968.

Such taxes are evidently intended primarily as a brake on excessive concentrations of wealth, and as a contribution towards the overall equity of the tax system. On the other hand, the existing structure of transfer taxes in Canada has been severely criticized for its inhibiting effect on economic growth and for the extent

to which it contributes to the sale of Canadian-owned businesses to foreign interests.* It is perhaps worth noting in this connection that the more generous U.S. treatment of interest costs incurred by one company in acquiring the shares of another company is an important contributory factor to the sale of Canadian business to U.S. interests.

From the point of view of their effect on economic growth, there appears to be little doubt that our present transfer taxes inhibit individual initiatives and enterprise, and discourage investment in new ventures having growth potential. Furthermore, the need for liquidity to meet estate tax and succession duty obligations promotes conservative investment policies on the part of Canadians who are in a position to finance new ventures.

It should be possible to reduce materially the harmful economic effects of transfer taxes without abandoning the legitimate objectives of such taxes. The most serious criticism of the present system of federal and provincial transfer taxes relates to the burden imposed on relatively small estates and on those of moderate size. Such estates do not produce a substantial portion of the relatively minor revenue obtained from this form of taxation, and they cannot be thought to represent dangerously large concentrations of wealth. On the other hand, as a constructive force, contributing to economic growth, it is reasonable to assume that the pursuit of wealth is much more powerful for individuals aiming at the

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* See Transfer Taxes: Their Effect on Productivity and Control of Our Economy, a study prepared by John K. Savage and D. VanDenBulcke for the Ontario Economic Council.

accumulation of medium to moderately large personal estates than for those who have already attained substantial wealth.

The grounds for concern over the adverse effects of transfer taxes on incentives would be greatly increased if the present taxes of this kind were to remain substantially unaltered in the event of the introduction of capital gains taxes in Canada. A general tax on capital gains would apply, even more directly than our present transfer taxes, to reduce the economic rewards for successful initiative and enterprise. Here again, it is the relationship between the Canadian tax system and that of other countries that has most significance. The introduction of a capital gains tax in Canada would promote conservative investment practices among Canadian investors, while leaving non-resident investors largely unaffected. New Canadian investment opportunities would be relatively less attractive to Canadians, and we would have to rely even more heavily than we now do on foreign initiative in the development of our resources and employment opportunities.

The combination of both forms of wealth taxation could well do significant damage to the productive capital base and the economic motivation on which the growth process depends. If the introduction of a general capital gains tax is considered to be essential in order to satisfy the requirements of equity, serious consideration should be given to a major withdrawal from the estate tax and succession duty fields in order to minimize the impact on incentives that would follow from duplication of both forms of taxation of wealth.

Taxation of income from foreign operations

An aspect of our tax structure that has more importance for Canada's prospects for economic growth than is generally recognized is the treatment accorded income derived from foreign operations of Canadian companies.

The principal issue involved concerns the desirability of adopting tax policies that would have the effect of discouraging foreign investment, and promoting domestic investment, by Canadian companies. While such a policy might appear appropriate at first glance, it could have most undesirable long-term implications for the future development of industry in Canada.

It is becoming increasingly evident that the future prospects for companies engaged in many major industries -- and particularly those in which major gains in productivity can be expected -- will depend on their ability to finance scientific research and product development, improve manufacturing and distribution techniques and managerial skills, and achieve economies that flow from large volume production. To do this will in many cases require operations on an international scale, with manufacturing, processing and distribution activities outside Canada to serve foreign markets.

If our tax treatment of income derived from foreign operations is designed to discriminate in favour of domestic investment, and against foreign investment, Canadian companies would be discouraged from seeking opportunities for expansion abroad, and would tend to concentrate their activities in industries in which they can expect to remain competitive without expansion beyond the limits imposed by the size of the market available to a company whose operations

are confined to Canada. Other industries, including those in which improvements in productivity are most likely to occur, would tend to become increasingly dominated by foreign-controlled international companies whose investment in Canadian operations are more likely to be confined to the activities required to be carried on in Canada in order to serve the local market.

It seems clear that it is very much in Canada's long term interest to work towards the elimination of taxation and other barriers to the development of international operations of Canadian-based companies, and to promote the free international movement of capital. Policies designed to promote domestic investment by Canadian companies through discriminatory tax treatment of income derived from foreign operations could do serious damage to the future development of industries essential to the growth of our exports and our total economic performance.

The role of incentives in the tax system

Various forms of tax incentives have been used in Canada as a means of stimulating the development of particular industries or to attract investment in particular regions. Some of these measures, such as the three year exemption for new mines and depletion allowances for the mining and petroleum industries, have proved highly effective in promoting rapid growth in industries that have contributed greatly both to the Canadian economy as a whole and to the reduction of regional disparities of wealth and opportunity. Others have proved less effective than other forms of government assistance. Special tax deductions in respect of scientific research expenditures, tax holidays and accelerated depreciation for new businesses in

designated areas, and many similar provisions have been employed from time to time with varying degrees of success, but have been largely abandoned in favour of programs involving assistance in the form of loans and grants.

An effective incentive to new investment must meet a number of requirements. In the first place it must be fairly easily understood, and guaranteed far enough in advance to permit adequate planning and to justify a long term commitment. It must be sufficiently generous to have a material effect on the economics of the type of investment to be promoted, and it must be designed to avoid dislocation of existing businesses. Generally, incentives related to the profits derived from new or expanded ventures have an advantage over incentives in the form of subsidies or grants related to costs. Incentives related to profits promote projects that have sound prospects of success, while those related to costs are more likely to result in uneconomic ventures requiring continuing government assistance.

Tax incentives, and particularly those related to profits, have been criticized on the grounds that their cost in terms of tax revenue is not readily apparent, and is thus not subject to public review in relation to the benefits derived. This objection would have some validity if the response to incentive programs could be measured with some degree of accuracy and the cost of alternative measures that would have produced equivalent results could be determined. However, in most cases it is not only virtually impossible to establish the actual cost of tax incentive measures in terms of revenue forgone (since this requires knowledge of what would have occurred in the absence of the incentive); it is even

more difficult to provide an accurate assessment of the benefits obtained. The latter requires an appraisal of the response to the incentive, both in terms of new investment, employment and production, and in terms of any lost investment, employment and production from other uses from which resources have been diverted by the incentive.

The fact that such comparisons can seldom be made with any degree of accuracy does not disqualify the use of tax incentives, or make the use of subsidies and other forms of assistance preferable. That the cost of a subsidy may be readily apparent is, of course, no assurance that it will produce greater benefits than a tax incentive of equivalent cost. The evident success of the tax incentives available to the Canadian mining and petroleum industries in promoting the phenomenal development that has occurred in the last quarter century in these industries illustrates this point. It is difficult to conceive of a program of grants or subsidies that could have achieved comparable results, let alone estimate the cost of such a program.

Tax incentives, and particularly those provided for the extractive industries, were also criticized by the Royal Commission on Taxation on the general grounds that they represent a departure from neutrality. As such, the Commission contended on theoretical grounds that they have caused a misallocation of resources by diverting capital and labour from other more productive uses. This evidently assumes that the capital attracted to these industries by tax incentives would otherwise have been invested elsewhere in Canada, and that other equally profitable employment would have been available for those who found jobs in the expanded mining and oil

industries. Such assumptions are clearly unwarranted. There is no justification for assuming that a major portion of the enormous volume of new capital attracted to the Canadian mining and petroleum industries, amounting to over $1 billion annually would have been invested in other Canadian industries, or that equally productive employment would have been provided for the labour force involved.

The evidence points strongly in the other direction. The tax incentives provided for the extractive industries have clearly been successful in stimulating highly productive investment, particularly in less developed regions of the country that offer little else in the way of investment opportunities. Not only does this appear to have been accomplished without depriving other potentially productive Canadian investment of needed capital and labour; on the contrary, the rapid growth in these industries has had a favourable effect on the whole economy, providing additional markets for many supporting industries and stimulating the development of processing, fabrication and secondary manufacturing industries.

Implications of major structural changes

The increasing complexity of our tax laws, made necessary by the high rates of tax now imposed and the developing sophistication of domestic and international business relationships, has added to the difficulty of ensuring adequate administration and enforcement, and has resulted in an unfortunate diversion of valuable skills from more productive activity. Business managers find it essential to devote more and more of their time to consideration of the tax implications of business decisions. To some degree this is inevitable in a society in which over one third of the gross national

product is required to finance government expenditures. However, it is important to avoid any unnecessary increase in the complication of our tax system, and to keep the consequent drain of talent from productive occupation to a minimum.

Major fundamental changes in the tax structure are likely to be particularly disruptive and wasteful. The recent experience of the United Kingdom in adopting a new system of corporation tax and a new capital gains tax, both at the same time, provides some indication of this, and a hint at the possible effects it may have on economic growth. Canada's own experience with much more limited tax reform measures, such as those introduced last year affecting gift and estate taxes and the taxation of insurance companies, suggests the desirability of proceeding cautiously, and in reasonably digestible stages.

Another related consideration affecting the choices open to Canada in revising and reforming its tax structure is the importance of maintaining a reasonable degree of international harmony in taxation. Unnecessary differences in tax laws act as an impediment to free international movements of capital and skilled people. Lack of familiarity with the laws of other countries is, in itself, a barrier. Difficulties encountered in accommodating business or personal affairs to fundamentally different systems of taxation can be even more serious. Canada's ability to attract foreign investment and skilled people is of such importance to our economic growth and ability to develop worthwhile employment opportunities that we should be careful not to create unnecessary obstacles of this kind.

Conclusion

The foregoing discussion has been concerned almost exclusively with the economic growth implications of various aspects of the tax structure. Very little has been said about considerations of equity which will, and should, affect the choices that are made. The emphasis placed on the effects of tax policy on economic growth is not intended to imply that the objective of achieving a fair distribution of the tax burden is unimportant, or that it is secondary in importance to the economic objectives. However, as noted at the beginning, public attention has been focused particularly on questions of equity in taxation, and this aspect is likely to dominate consideration of tax reform proposals to the detriment of other important considerations.

There is usually more than one way to skin a cat, and much the same can be said about the elimination of serious inequities in the tax system. The desirability of changes designed to improve the fairness of the tax system should not be judged solely from this point of view. If they would be likely to have an adverse effect on economic growth, consideration must also be given to alternative possibilities that would do less damage to the economy.

Economic implications of proposed changes in the tax structure are likely to be given less attention than they deserve, due partly to a general lack of understanding of the influence of tax policy on economic growth, and partly to a tendency to ignore or forget the importance of economic growth to the achievement of social goals. By directing particular attention to those aspects of our tax structure that can have an important effect on Canada's economic growth, it is hoped that this study will serve a useful purpose.

Date Due